COOPERATIVE BANKSHARES INC
Form 10-Q
August 14, 2002

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington D.C. 20549

FORM 10-Q

(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2002

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ________ to ________

Commission File Number: 0-24626

COOPERATIVE BANKSHARES, INC.
(Exact name of registrant as specified in its charter)

North Carolina	56-1886527
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
201 Market Street, Wilmington, North Carolina	28401
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (910) 343-0181

Former name, former address and former fiscal year, if changed since last report.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 of 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

[X] Yes [ ] No

APPLICABLE ONLY TO CORPORATE ISSUERS: Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. 2,835,947 shares at July 31, 2002

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	JUNE 30, 2002 (unaudited)	December
ASSETS		
Cash and due from banks, noninterest-bearing	$ 11,486,565	$ 10,
Interest-bearing deposits in other banks	2,386,990	1,
Total cash and cash equivalents	13,873,555	12,
Securities:		
Available for sale (amortized cost of $39,263,986 in June 2002 and $42,661,527 in December 2001)	39,598,524	42,
Held to maturity (estimated market value of $9,018,725 in June 2002 and $5,282,815 in December 2001)	8,838,807	5,

FHLB stock	4,154,900	4,
Loans held for sale	6,557,504	
Loans	387,462,919	375,
Less allowance for loan losses	2,591,792	2,
Net loans	384,871,127	373,
Other real estate owned	1,283,041	
Accrued interest receivable	2,388,917	2,
Premises and equipment, net	6,594,514	6,
Other assets	11,273,681	10,
Total assets	$479,434,570	$458,
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits	$360,535,738	$339,
Short-term borrowings	37,833,591	35,
Escrow deposits	648,267	
Accrued interest payable	267,443	
Accrued expenses and other liabilities	1,279,012	1,
Long-term obligations	43,094,905	48,
Total liabilities	443,658,956	424,
Stockholders' equity:		
Preferred stock, $1 par value, 3,000,000 shares authorized, no shares issued and outstanding	--	
Common stock, $1 par value, 7,000,000 shares authorized, 2,835,947 and 2,835,447 shares issued and outstanding	2,835,947	2,
Additional paid-in capital	2,440,644	2,
Accumulated other comprehensive income	204,068	
Retained earnings	30,294,955	28,
Total stockholders' equity	35,775,614	33,
Total liabilities and stockholders' equity	$479,434,570	$458,
Book value per common share	$ 12.62	$

*Derived from audited consolidated financial statements

The accompanying notes are an integral part of the consolidated financial statements.

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COOPERATIVE BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	THREE MONTHS ENDED JUNE 30, 2002	2001	
INTEREST INCOME:			
Loans	$6,653,357	$7,006,622	$13,
Securities	673,851	696,892	1,

Other	11,625	58,129	
Dividends on FHLB stock	54,384	63,197	
Total interest income	7,393,217	7,824,840	14,
INTEREST EXPENSE:			
Deposits	2,610,028	3,967,552	5,
Borrowed funds	892,076	855,064	1,
Total interest expense	3,502,104	4,822,616	7,
NET INTEREST INCOME	3,891,113	3,002,224	7,
Provision for loan losses	120,000	90,000	
Net interest income after provision for loan losses	3,771,113	2,912,224	7,
NONINTEREST INCOME:			
Net gains on sale of loans	79,388	2,420	
Net gains on sale of securities	18,417	12,399	
Service charges and fees on loans	136,374	176,498	
Deposit-related fees	262,693	243,138	
Gain (loss) on sale of premises and equipment	--	--	
Bank-owned life insurance earnings	99,837	--	
Other income, net	42,858	27,667	
Total noninterest income	639,567	462,122	1,
NONINTEREST EXPENSE:			
Compensation and fringe benefits	1,570,690	1,269,547	3,
Occupancy and equipment	549,184	521,985	1,
Advertising	66,317	64,485	
Real estate owned	3,985	(1,548)	
Other	457,024	421,001	
Total noninterest expenses	2,647,200	2,275,470	5,
Income before income taxes	1,763,480	1,098,876	3,
Income tax expense	632,318	395,972	1,
NET INCOME	$1,131,162	$ 702,904	$ 2,
NET INCOME PER SHARE:			
Basic	$ 0.40	$ 0.25	$
Diluted	$ 0.40	$ 0.25	$
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:			
Basic	2,835,508	2,800,975	2,
Diluted	2,861,143	2,816,418	2,

The accompanying notes are an integral part of the consolidated financial statements.

COOPERATIVE BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(UNAUDITED)

	COMMON STOCK	ADDITIONAL PAID-IN CAPITAL	ACCUMULATED OTHER COMPREHENSIVE INCOME NET	RET EAR
Balance, December 31, 2001	$ 2,835,447	$ 2,435,720	$ 188,278	$ 28,
Exercise of stock options	500	4,924	--	
Other comprehensive income, net of taxes	--	--	15,790	
Net income	--	--	--	2,
Cash dividend ($.10 per share)	--	--	--	(
Balance, June 30, 2002	$ 2,835,947	$ 2,440,644	$ 204,068	$ 30,

The accompanying notes are an integral part of the consolidated financial statements.

COOPERATIVE BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	SIX 2002
OPERATING ACTIVITIES:	
Net income	$ 2,419,664
Adjustments to reconcile net income to net cash provided by operating activities:	
Net accretion, amortization, and depreciation	464,730
Net gain on sale of securities	(135,182
Net gain on sale of loans	(97,668
Provision for deferred income taxes	107,938
Loss (gain) on sale of premises and equipment	(464,977
Gain on sales of foreclosed real estate	-
Valuation losses on foreclosed real estate	108,446
Provision for loan losses	400,000
Proceeds from sale of loans	5,826,611
Loan originations held for sale	(12,286,447
Changes in assets and liabilities:	
Accrued interest receivable	248,450
Prepaid expenses and other assets	(311,859
Accrued interest payable	3,052
Accrued expenses and other liabilities	184,102
Net cash provided (used) by operating activities	(3,533,140
INVESTING ACTIVITIES:	
Purchases of securities available for sale	(21,882,903
Purchase of Lumina Mortgage Company	(772,610

Proceeds from sale of securities available for sale	19,058,014
Proceeds from maturity of securities available for sale	2,435,511
Proceeds from maturity of securities held to maturity	-
Loan originations, net of principal repayments	(12,450,903
Proceeds from disposals of foreclosed real estate	101,908
Additions to other real estate owned	(96,455
Purchases of premises and equipment	(466,744
Proceeds from sale of premises and equipment	499,070
Net cash used in investing activities	(13,575,112
FINANCING ACTIVITIES:	
Net increase in deposits	20,705,686
Net change in short-term borrowings	(2,168,660
Proceeds from issuance of common stock	5,424
Dividends paid	(283,544
Net change in escrow deposits	427,323
Net cash provided by financing activities	18,686,229
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	1,577,977
CASH AND CASH EQUIVALENTS:	
BEGINNING OF PERIOD	12,295,578
END OF PERIOD	$ 13,873,555

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COOPERATIVE BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS, CONTINUED

	SIX MONTHS EN JUNE 30,
	2002
Cash paid for:	
Interest	$ 7,257,047
Income taxes	1,192,763
Summary of noncash investing and financing activities:	
Transfer from loans to foreclosed real estate	637,668
Unrealized gain on securities available for sale, net of taxes	15,790
Transfer of securities from held to maturity to available for sale-fair value	--

The accompanying notes are an integral part of the consolidated financial statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Accounting Policies: The significant accounting policies followed by Cooperative Bankshares, Inc. (the "Company") for interim financial

reporting are consistent with the accounting policies followed for annual financial reporting. These unaudited consolidated financial statements have been prepared in accordance with Rule 10-01 of Regulation S-X, and, in management's opinion, all adjustments of a normal recurring nature necessary for a fair presentation have been included. The accompanying financial statements do not purport to contain all the necessary financial disclosures that might otherwise be necessary in the circumstances and should be read in conjunction with the consolidated financial statements and notes thereto in the Company's annual report for the year ended December 31, 2001. The results of operations for the three and six-month periods ended June 30, 2002 are not necessarily indicative of the results to be expected for the full year.

2. Basis of Presentation: The accompanying unaudited consolidated financial statements include the accounts of Cooperative Bankshares, Inc., Cooperative Bank For Savings, Inc., SSB and its wholly owned subsidiary, CS&L Services, Inc. All significant intercompany items have been eliminated. Certain items for prior periods have been reclassified to conform to the current period presentation. These reclassifications have no effect on the net income or stockholders' equity as previously reported.

3. Earnings Per Share: Earnings per share are calculated by dividing net income by the sum of the weighted average number of common shares outstanding and potential common shares. Potential common stock consists of stock options issued and outstanding. In determining the number of potential common stock, the treasury stock method was applied. This method assumes that the number of shares issuable upon exercise of the stock options is reduced by the number of common shares assumed purchased at market prices with the proceeds from the assumed exercise of the common stock options plus any tax benefits received as a result of the assumed exercise. The following table provides a reconciliation of income available to common stockholders and the average number of shares outstanding for the periods below:

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	2002	2001	2002	2001
Net income (numerator)	$1,131,162	$ 702,904	$2,419,664	$1,277,256
Shares for basic EPS (denominator)	2,835,508	2,800,975	2,835,478	2,774,243
Dilutive effect of stock options	25,635	15,443	17,724	42,054
Shares for diluted EPS (denominator)	2,861,143	2,816,418	2,853,202	2,816,297

4. Comprehensive Income: Comprehensive income includes net income and all other changes to the Company's equity, with the exception of transactions with shareholders ("other comprehensive income"). The Company's only components of other comprehensive income relate to unrealized gains and losses on available for sale securities. The following table sets forth the components of other comprehensive income and total comprehensive income for the three and six months ended June 30:

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	2002	2001	2002	2001
Net income	$ 1,131,162	$ 702,904	$ 2,419,664	$ 1,277,2
Other comprehensive income				
Reclassification adjustment for realized gain on available for sale securities	(18,417)	(12,399)	(135,182)	(12,3
Unrealized gain (losses) on available for sale securities arising during the period	1,064,830	(94,326)	161,067	107,1
Income tax (expense) benefit	(408,101)	41,623	(10,095)	(36,9
Other comprehensive income (loss)	638,312	(65,102)	15,790	57,7
Comprehensive income	$ 1,769,474	$ 637,802	$ 2,435,454	$ 1,335,0

5. New Accounting Pronouncements: On January 1, 2001, the Company adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities". The statement is effective for fiscal years beginning after June 15, 2000, with earlier adoption permitted, as amended by SFAS No. 137. SFAS No. 133 establishes accounting and reporting standards for derivative instruments and for hedging activities. The statement requires an entity

to recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. On January 1, 2001, the Company transferred held-to-maturity investment securities with an amortized cost of approximately $5,978,000 to the available-for-sale category at fair value as allowed by SFAS No. 133. The unrealized loss at the time of transfer of approximately $32,000 before tax has been included in other comprehensive income, net of tax. Such transfers from the held-to-maturity category at the date of initial adoption shall not call into question the Company's intent to hold other debt securities to maturity in the future.

The Company does not engage in any hedging activities except for the buy and sell commitments for loans held for sale, which are deemed immaterial due to the fact the Company issues a rate lock commitment to a customer and concurrently "locks in" the loan with a secondary market investor under a best efforts delivery mechanism. Therefore, market risk is mitigated because any commitments to fund a loan available for sale is concurrently hedged by a commitment from an investor to purchase the loan under the same terms. Loans are usually sold within 60 days after closing. Other than the aforementioned transfer of securities, the adoption of the statement had no material impact on the Company.

On July 1, 2001, the Company adopted SFAS No. 141, "Business Combinations". This Statement improves the transparency of the accounting and reporting for business combinations by requiring that all business combinations be accounted for under a single method - the purchase method. Use of the pooling-of-interests method is no longer permitted. SFAS No. 141 requires that the purchase method be used for business combinations initiated after June 30, 2001. The purchase method was used in recording the acquisition of

Lumina Mortgage Company.

On January 1, 2002, the Company adopted SFAS No. 142 "Goodwill and Other Intangible Assets". This Statement requires that goodwill no longer be amortized to earnings, but instead be reviewed for impairment. The Company did not have any goodwill until the purchase of Lumina Mortgage Company. This purchase has created goodwill in the amount of $661,000 at June 30, 2002. In accordance with Statement No. 142, this goodwill will not be amortized since it has an indefinite useful life but instead will be tested for impairment at least annually.

6. Real Estate Sale: During February 2002, the Bank sold a parking lot for $500,000. A gain of $464,977 was realized on the sale.

7. Loans Held for Sale: As a part of the normal business operations, the Company originates mortgage loans that have been pre-approved by secondary investors. The Company issues a rate lock commitment to a customer and concurrently "locks in" with a secondary market investor under a best efforts delivery mechanism. The terms of the loan are set by the secondary investors and are transferred to them at par within several weeks of the Company initially funding the loan. The Company receives origination fees from borrowers and servicing release premiums from the investors that are recognized on the Statement of Operations in the line item "net gains on sale of loans". Between the initial funding of the loans by the Company and the subsequent purchase by the investor, the Company carries the loans on its balance sheet at cost.

8. Acquisition: On May 31, 2002, the Bank acquired the operating assets of Wilmington-based Lumina Mortgage Company ("Lumina"). The combined resources of these two companies will allow the Bank to become the premier mortgage lender in the Wilmington market and enable Cooperative Bank to offer a wider range of products to a larger customer base. Lumina has offices in Wilmington, North Carolina, North Myrtle Beach, South Carolina and Virginia Beach, Virginia. Their 2001 loan originations totaled $118 million. The purchase price was $740,000 in cash with two future contingent payments based on loan origination volume and meeting certain profitability goals of Lumina in the two subsequent years after the purchase. Due to the uncertainties surrounding the determination of the contingent payments, such payments have not been recorded. The two contingent payments are estimated to be approximately $300,000 each and will be recorded as additional purchase price. At June 30, 2002, the goodwill created by this transaction was $661,000.

Lumina borrows money on a short-term basis to fund its loans that are held for sale. At June 30, 2002 the balance of this borrowing was $6.5 million at a rate of 4.09%. This borrowing is collateralized by mortgage loans held for sale. When a loan is sold, the proceeds are used to repay the borrowing. Loans are usually sold within 60 days. This borrowing agreement provides for a maximum line of credit up to $10 million.

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The following table summarizes the estimated fair value of assets acquired and liabilities assumed at May 31, 2002 but does not include $32,549 of professional fees that were included in goodwill as part of this transaction:

Premises and equipment	$ 71,584
Goodwill	628,416
Other Assets	51,729
Total assets acquired	$751,729
Accrued expenses and other liabilities	11,668
Total liabilities assumed	11,668
Net assets acquired	$740,061

Presented below are the pro-forma consolidated condensed statements of income, for the Company and Lumina Mortgage Company, for the three and six month periods ended June 30, 2002 and 2001, assuming the acquisition was completed at the beginning of all periods presented. The unaudited pro-forma information presented below is not necessarily indicative of the results of operations that would have resulted had the merger been completed at the beginning of the applicable periods presented, nor is it necessarily indicative of the results of operations in future periods.

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	2002	2001	2002	2001
Interest income	$ 7,465,700	$ 7,937,893	$14,900,817	$15,968,99
Interest expense	3,551,085	4,927,161	7,358,060	10,003,79
Net interest income	3,914,615	3,010,732	7,542,757	5,965,20
Provision for loan losses	120,000	90,000	400,000	180,00
Net interest income after provision for loan losses	3,794,615	2,920,732	7,142,757	5,785,20
Noninterest income	1,339,363	1,300,804	3,248,751	2,554,46
Noninterest expense	3,313,973	3,030,890	6,530,817	6,159,77
Income before income taxes	1,820,005	1,190,646	3,860,691	2,179,89
Income tax expense	654,363	431,762	1,372,067	790,67
NET INCOME	$ 1,165,642	$ 758,884	$ 2,488,624	$ 1,389,21
NET INCOME PER SHARE:				
Basic	$ 0.41	$ 0.27	$ 0.88	$ 0.5
Diluted	$ 0.41	$ 0.27	$ 0.87	$ 0.4

ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

GENERAL

Cooperative Bankshares, Inc. (the "Company") is a registered bank holding company incorporated in North Carolina in 1994. The Company was formed for the purpose of serving as the holding company for Cooperative Bank for Savings, Inc., SSB ("Cooperative Bank" or the "Bank"), a North Carolina chartered savings bank. The Company's primary activities consist of holding the stock of Cooperative Bank and operating the business of the Bank. Accordingly, the information set forth in this report, including financial statements and related data, relates primarily to Cooperative Bank.

Cooperative Bank was chartered in 1898 and is headquartered in Wilmington, North Carolina. The Bank operates 17 financial centers throughout the coastal and inland communities of eastern North Carolina. These centers extend from Corolla, located on the Outer Banks of North Carolina, to Tabor City, located on the South Carolina border. The Bank's deposit accounts are insured up to applicable limits by the Federal Deposit Insurance Corporation ("FDIC").

Through its financial centers, the Bank provides a wide range of banking products, including interest bearing and non-interest bearing checking accounts, certificates of deposit and individual retirement accounts. It offers an array of loan products: overdraft protection, commercial, consumer, agricultural, real estate, residential mortgage and home equity loans. Also offered are safe deposit boxes and automated banking services through ATMs and Access24 Phone Banking. In addition, the Bank offers discount brokerage services, annuity sales and mutual funds through a third party arrangement with UVEST Investment Services. The Bank also offers a wide range of mortgage loan products through its subsidiary, CS&L Services. On May 31, 2002, the Bank acquired Wilmington-based Lumina Mortgage Company. Lumina Mortgage has offices in Wilmington, North Carolina, North Myrtle Beach, South Carolina and Virginia Beach, Virginia. Their 2001 loan originations totaled $118 million. Management expects this acquisition to be accretive to earnings during the year ended 2002.

MISSION STATEMENT

It is the mission of the Company to provide the maximum in safety and security for our depositors, an equitable rate of return for our stockholders, excellent service for our customers, and to do so while operating in a fiscally sound and conservative manner, with fair pricing of our products and services, good working conditions, outstanding training and opportunities for our staff, along with a high level of corporate citizenship.

MANAGEMENT STRATEGY

Cooperative Bank's lending activities have traditionally concentrated on the origination of loans for the purpose of constructing, financing or refinancing residential properties. In recent years however, the Bank has emphasized origination of nonresidential real estate loans and secured and unsecured consumer and business loans. As of June 30, 2002, approximately $274 million, or 71%, of the Bank's loan portfolio consisted of loans secured by residential properties. This has changed from approximately $273 million, or 73% at December 31, 2001. The Bank originates adjustable rate and fixed rate loans. As of June 30, 2002, adjustable rate and fixed rate loans totaled approximately 63.5% and 36.5%, respectively, of the Bank's total loan portfolio.

The Bank has chosen to sell a larger percentage of its fixed rate mortgage loan originations through brokered arrangements. This enables the Bank to reinvest these funds in commercial loans, while increasing fee income. This is part of the continuing effort to restructure the balance sheet and operations to be more reflective of a commercial bank.

INTEREST RATE SENSITIVITY ANALYSIS

Interest rate sensitivity refers to the change in interest spread resulting from changes in interest rates. To the extent that interest income and interest expense do not respond equally to changes in interest rates, or that all rates do not change uniformly, earnings will be affected. Interest rate sensitivity, at a point in time, can be analyzed using a static gap analysis that measures the match in balances subject to repricing between interest-earning assets and interest-bearing liabilities. Gap is considered positive when the amount of interest rate sensitive assets exceed the amount of interest rate sensitive liabilities. Gap is considered negative when the amount of interest rate sensitive liabilities exceed the amount of interest rate sensitive assets.

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At June 30, 2002, Cooperative had a one-year cumulative gap position of a negative 3.2%. During a period of rising interest rates, a negative gap would tend to adversely affect net interest income, while a positive gap would tend to result in an increase in net interest income. During a period of falling interest rates, a negative gap would tend to result in an increase in net interest income while a positive gap would tend to adversely affect net interest income. It is important to note that certain shortcomings are inherent in static gap analysis. Although certain assets and liabilities may have similar maturities or periods of repricing, they may react in different degrees to changes in market interest rates. For example, a part of the Company's adjustable-rate mortgage loans are indexed to the National Monthly Median Cost of Funds to SAIF-insured institutions. This index is considered a lagging index that may lag behind changes in market rates. The one-year or less interest-bearing liabilities also include checking, savings, and money market deposit accounts. Experience has shown that the Company sees relatively modest repricing of these transaction accounts. Management takes this into consideration in determining acceptable levels of interest rate risk.

When Lumina gives a rate lock commitment to a customer, there is a concurrent "lock in" for the loan with a secondary market investor under a best efforts delivery mechanism. Therefore interest rate risk is mitigated because any commitments to fund a loan available for sale is concurrently hedged by a commitment from an investor to purchase the loan under the same terms. Loans are usually sold within 60 days after closing.

CONTRACTUAL OBLIGATIONS AND COMMITMENTS

The Bank enters into agreements that obligate it to make future payments under contracts, such as debt and lease agreements. In addition, the Bank commits to lend funds in the future such as credit lines and loan commitments at June 30, 2002 (in thousands).

	Payments Due by Perio		
Contractual Obligations	Total	Less than 1 year	1-3 years
Borrowed Funds	$ 80,928	$ 37,834	$20,000
Lease Obligations	1,920	317	408
Deposits	360,536	305,040	55,323
Total Contractual Cash Obligations	$443,384	$343,191	$75,731

Off Balance Sheet Commitments	Amount of Commitment Expi Per Period		
	Total Amounts Committed	Less than 1 year	1-3 years
Undisbursed portion of home equity loans collateralized primarily by junior liens on 1-4 family properties	$ 12,739	$ 1,444	$ 176
Other commitments and credit lines	12,668	10,205	633
Undisbursed portion of construction loans	33,023	33,023	-
Fixed-rate mortgage loan commitments	601	601	-
Adjustable-rate mortgage loan commitments	1,866	1,866	-
Commitments to sell loans	6,558	6,558	-
Total Commitments	$ 67,455	$ 53,697	$ 809

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LIQUIDITY

The Company's goal is to maintain adequate liquidity to meet potential funding needs of loan and deposit customers, pay operating expenses, and meet regulatory liquidity requirements. Maturing securities, principal repayments of loans and securities, deposits, income from operations and borrowings are the main sources of liquidity. The Bank has been granted a line of credit by the Federal Home Loan Bank of Atlanta ("FHLB") in an amount of up to 25% of the Bank's total assets. At June 30, 2002, the Bank's borrowed funds from the FHLB equaled 15.5% of its total assets. Scheduled loan repayments are a relatively predictable source of funds, unlike deposits and loan prepayments that are significantly influenced by general interest rates, economic conditions and competition.

At June 30, 2002, the estimated market value of liquid assets (cash, cash equivalents, marketable securities and loans held for sale) was approximately $69.0 million, which represents 15.6% of deposits and borrowed funds as compared to $60.5 million or 14.3% of deposits and borrowed funds at December 31, 2001. The increase in liquid assets was primarily due to an increase in loans held for sale that was funded with short term borrowings.

The Company's primary uses of liquidity are to fund loans and to make investments. At June 30, 2002, outstanding off-balance sheet commitments to extend credit totaled $27.9 million, and the undisbursed portion of construction loans was $33.0 million. Management considers current liquidity levels adequate to meet the Company's cash flow requirements.

CAPITAL

Stockholders' equity at June 30, 2002, was $35.8 million, up 6.4% from $33.6 million at December 31, 2001. Stockholders' equity at June 30, 2002 and December 31, 2001, includes unrealized gains, net of tax, of $204,000 and $188,000, respectively, on securities available for sale marked to estimated fair market value.

Under the capital regulations of the FDIC, the Bank must satisfy minimum leverage ratio requirements and risk-based capital requirements. Banks supervised by the FDIC must maintain a minimum leverage ratio of core (Tier I) capital to average adjusted assets ranging from 3% to 5%. At June 30, 2002, the Bank's ratio of Tier I capital was 7.56%. The FDIC's risk-based capital rules require banks supervised by the FDIC to maintain risk-based capital to risk-weighted assets of at least 8.00%. Risk-based capital for the Bank is defined as Tier I capital plus the balance of allowance for loan losses. At June 30, 2002, the Bank had a ratio of qualifying total capital to risk-weighted assets of 11.14%.

The Company, as a bank holding company, is also subject, on a consolidated basis, to the capital adequacy guidelines of the Board of Governors of the Federal Reserve (the "Federal Reserve Board"). The capital requirements of the Federal Reserve Board are similar to those of the FDIC governing the Bank.

The Company currently exceeds all of its capital requirements. Management expects the Company to continue to exceed these capital requirements without altering current operations or strategies.

On June 20, 2002, the Company's Board of Directors approved a quarterly cash dividend of $.05 per share. The dividend was paid on July 16, 2002 to stockholders of record as of July 1, 2002. Any future payment of dividends is dependent on the financial condition, and capital needs of the Company, requirements of regulatory agencies, and economic conditions in the marketplace.

CRITICAL ACCOUNTING POLICY

The Company's only critical accounting policy is the determination of its allowance for loan losses. A critical accounting policy is one that is both very important to the portrayal of the Company's financial condition and results, and requires management's most difficult, subjective or complex judgments. What makes these judgments inherently difficult, subjective and/or or complex is the need to make estimates about the effects of matters that are inherently uncertain. For further information on the allowance for loan losses, see "Financial Condition" in Management's Discussion and Analysis and Note 3 of "Notes to Consolidated Financial Statements" included in the 2001 Annual Report.

FINANCIAL CONDITION AT JUNE 30, 2002, COMPARED TO DECEMBER 31, 2001

The Company's total assets increased 4.7% to $479.4 million at June 30, 2002, as compared to $458.1 million at December 31, 2001. There was an increase of $1.6 million (12.8%) in cash and cash equivalents, which was caused by an increase in deposits of $20.7 million (6.1%). The increase in deposits was primarily in the seven month certificates due to favorable pricing and the customers' desire to stay short in the current rate environment. The

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Bank also attracted an additional $6.7 million in internet deposits because the rates were competitive with the Bank's local markets. Internet deposits are primarily obtained from other financial institutions in increments of $99,000, with terms primarily of one or two years. The rise in deposits also enabled the Bank to fund an increase in loans of $11.5 million (3.1%) and repay $9.0 million of borrowed funds from the FHLB. Borrowed funds, collateralized through an agreement with the FHLB for advances, are secured by the Bank's investment in FHLB stock and qualifying first mortgage loans. There was an increase of $6.6 million in loans held for sale, which was funded by a short term borrowing at another financial institution. This loan is collateralized by the loans held for sale. Both the loans held for sale and the corresponding borrowing are new since December 31, 2001, and are a result of the Lumina Mortgage Company purchase. At June 30, 2002, $37.8 million in borrowed funds mature in 1 year and $20.0 million of funds mature in 2 years. The remaining amount of borrowed funds matures in 2010 or 2011.

The Company's non-performing assets (loans 90 days or more delinquent and foreclosed real estate) were $1.5 million, or .32% of assets, at June 30, 2002, compared to $3.8 million, or 0.84% of assets, at December 31, 2001. The majority of this reduction was due to over $1.1 million of loans being paid off in the first half of 2002 that were classified as non-performing at December 31, 2001. In addition, $331,000 in loans were charged off during this period. Foreclosed real estate increased to $1.3 million at June 30, 2002, from $800,000 at December 31, 2001, but only three properties make up this balance. The Company assumes an aggressive position in collecting delinquent loans and disposing of foreclosed assets to minimize balances of non-performing assets and continues to evaluate the loan and real estate portfolios to provide loss reserves as considered necessary. For further information see "Comparison of Operating Results - Provision and Reserve for Loan Losses".

COMPARISON OF OPERATING RESULTS

OVERVIEW

The net income of the Company depends primarily upon net interest income. Net interest income is the difference between the interest earned on loans, the securities portfolios and interest earning deposits and the cost of funds, consisting principally of the interest paid on deposits and borrowings. The Company's operations are materially affected by general economic conditions, the monetary and fiscal policies of the Federal government, and the policies of regulatory authorities.

NET INCOME

Net income for the three and six-month periods ended June 30, 2002, increased 60.9% to $1.1 million and 89.4% to $2.4 million respectively, as compared to the same period last year. The increase in net income for the six-month period ended June 30, 2002 can be attributed to increases in net interest income of $1.5 million and noninterest income of $1.1 million. These increases were partially offset by increases in the provision for loan losses of $220 thousand, noninterest expense of $550 thousand and income taxes of $610 thousand during the same period.

INTEREST INCOME

For the three-month period ended June 30, 2002, interest income decreased 5.5% as compared to the same period a year ago. The average balance of interest-earning assets increased 6.9% but the average yield decreased 89 basis points as compared to the same period a year ago. Interest income decreased 6.3% for the six-month period ended June 30, 2002, as compared to the same period a year ago. The decrease in interest income can be attributed to the yield on average interest-earning assets decreasing to 6.82% as compared to 7.78% for the same period a year ago. The average balance of interest-earning assets increased 7.0% for the six month period ended June 30, 2002, as compared to the same period a year ago. The increase in the average balance of interest-earning assets had a positive effect on interest income while the reduction in yield had a negative impact on interest income.

INTEREST EXPENSE

Interest expense decreased 27.4% for the three-month period ended June 30, 2002, as compared to the same period a year ago. This decrease was due to the average cost of interest-bearing liabilities decreasing 174 basis points as compared to the same period a year ago. In the six-month period ended June 30, 2002, interest expense decreased 25.9% as compared to the same period a year ago. The average balance of interest-bearing liabilities increased 9.6% as compared to the same period a year ago. The cost of interest-bearing liabilities decreased to 3.57% as compared to 5.28% for the same period last year.

NET INTEREST INCOME

Net interest income for the three and six-month periods ended June 30, 2002, as compared to the same period a year ago, increased 29.6% and 26.0%, respectively. The increase was due to a larger decrease in the cost of liabilities versus the yield on assets, which can be attributed to the fact that certificates of deposit continue to reprice at lower yields caused by the rate reductions in 2001. See "Average Yield/Cost Analysis" tables for further information on interest income and interest expense.

AVERAGE YIELD/COST ANALYSIS

The following table contains information relating to the Company's average balance sheet and reflects the average yield on assets and average cost of liabilities for the periods indicated. Such annualized yields and costs are derived by dividing income or expense by the average balances of assets or liabilities, respectively, for the periods presented. The average loan portfolio balances include nonaccrual loans.

	For the three months			
	JUNE 30, 2002			
(DOLLARS IN THOUSANDS)	Average Balance	Interest	Average Yield/ Cost	Average Balance
Interest-earning assets:				
Interest-bearing deposits in other banks	$ 2,604	$ 12	1.84%	$ 8,886
Securities:				
Available for sale	41,171	559	5.43%	37,927
Held to maturity	7,216	115	6.37%	8,000
FHLB stock	4,155	54	5.20%	3,755
Loan portfolio	380,417	6,653	7.00%	348,987
Total interest-earning assets	435,563	7,393	6.79%	407,555
Non-interest earning assets	27,238			12,583
Total assets	$462,801			$420,138
Interest-bearing liabilities:				
Deposits	$336,202	$2,610	3.11%	$316,673
Borrowed funds	72,460	892	4.92%	56,410
Total interest-bearing liabilities	408,662	3,502	3.43%	373,083
Non-interest bearing liabilities	19,098			15,013
Total liabilities	427,760			388,096
Stockholders' equity	35,041			32,042

Total liabilities and stockholders' equity	$462,801			$420,138
Net interest income		$3,891		
Interest rate spread			3.36%	
Net yield on interest-earning assets			3.57%	
Percentage of average interest-earning assets to average interest-bearing liabilities			106.6%	

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AVERAGE YIELD/COST ANALYSIS

The following table contains information relating to the Company's average balance sheet and reflects the average yield on assets and average cost of liabilities for the periods indicated. Such annualized yields and costs are derived by dividing income or expense by the average balances of assets or liabilities, respectively, for the periods presented. The average loan portfolio balances include nonaccrual loans.

	For the six months en JUNE 30, 2002			
(DOLLARS IN THOUSANDS)	Average Balance	Interest	Average Yield/ Cost	Average Balance
Interest-earning assets:				
Interest-bearing deposits in other banks	$ 2,707	$ 24	1.77%	$ 12,189
Securities:				
Available for sale	42,285	1,166	5.51%	32,680
Held to maturity	6,108	204	6.68%	8,061
FHLB stock	4,155	113	5.44%	3,755
Loan portfolio	377,682	13,249	7.02%	347,877
Total interest-earning assets	432,937	14,756	6.82%	404,562
Non-interest earning assets	27,709			12,391
Total assets	$459,646			$416,953
Interest-bearing liabilities:				
Deposits	$331,507	$ 5,454	3.29%	$315,507
Borrowed funds	75,443	1,806	4.79%	55,756
Total interest-bearing liabilities	406,950	7,260	3.57%	371,263

Non-interest bearing liabilities	17,979			13,956
Total liabilities	424,929			385,219
Stockholders' equity	34,717			31,734
Total liabilities and stockholders' equity	$459,646			$416,953
Net interest income		$ 7,496		
Interest rate spread			3.25%	
Net yield on interest-earning assets			3.46%	
Percentage of average interest-earning assets to average interest-bearing liabilities			106.4%	

PROVISION AND RESERVE FOR LOAN LOSSES

During the six-month period ended June 30, 2002 the Bank had net charge-offs against the allowance for loan losses of $331,000 compared to $50,000 for the same period in 2001. This increase was due to one credit of $189,000,

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which previously had been placed in the non-accrual status, being charged off and three loans that were written down to the fair value of the collateral at the time of foreclosure. The Bank recorded $400,000 as a provision for loan losses for the current six-month period, increasing the balance of the allowance for loan losses to $2.6 million at June 30, 2002 as compared to recording a $180,000 provision for the same period last year. The increase in the provision was primarily caused by a continued emphasis to grow the Bank's commercial loan portfolio. Management considers the current level of the provision to be appropriate based on loan composition, the current level of delinquencies and other non-performing assets, overall economic conditions and other factors. Future increases to the allowance may be necessary due to changes in loan composition or loan volume, changes in economic or market area conditions and other factors. Additionally, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the recognition of additions to the allowance for loan losses based on their judgments of information available to them at the time of their examination.

NONINTEREST INCOME

Noninterest income increased by 110.8% for the six-month period ended June 30, 2002, as compared to the same period a year ago. The change in noninterest income can be attributed to a $465,000 gain on the sale of real estate and Bank-owned life insurance earnings of $200,000. No similar transactions occurred during the six months ended June 30, 2001. During February 2002, the Bank sold a parking lot for $500,000 which caused the gain on the sale of real estate. The

Bank-owned life insurance was purchased at the end of September 2001. In addition, net gains on sale of securities increased $123,000 for the six-month period ended June 30, 2002, as compared to the same period last year. The gain on securities was due primarily to selling bonds and purchasing mortgage backed securities to give the Bank greater cash flow in the event of rising rates. Also, net gains on sale of loans increased to $98,000 for the six-month period ended June 30, 2002, as compared to $2,000 for the same period a year ago. This increase was primarily due to increased loan sale volume resulting from the purchase of Lumina Mortgage Company. For the six-month period ended June 30, 2002, as compared to the same period a year ago, other income increased $58,000 in the current period. This increase was mainly due to an increase in commissions from annuity sales and mutual funds, through UVEST Investment Services.

In the three-month period ended June 30, 2002, noninterest income increased 38.4% as compared to the same period last year. The net gains on sale of loans, Bank-owned life insurance and other income net increased $77,000, $100,000 and $15,000 respectively, for the three-month period ended June 30, 2002, as compared to the same period a year ago. The reasons for these increases are the same as stated above for the six month period. In addition, deposit-related fees increased 8.0% for the three-month period ended June 30, 2002, as compared to the same period last year. This increase is primarily due to an increase in ATM revenues, which was caused by an increase in both the fee and the number of ATMs in operation. During the same three-month period, service charges and fees on loans decreased 22.7% as compared to last year. This reduction was primarily caused by a reduction in loan settlement service fees due to the large number of mortgage refinances made during the three-months ended June 30, 2001.

NONINTEREST EXPENSES

For the six-month period ended June 30, 2002, noninterest expense increased 11.8% as compared to the same period last year. Compensation and related costs increased 17.2%. The increase was due to increases in incentive based pay, costs of benefits, staffing levels and normal increases in salaries, as well as higher personnel costs as a result of the purchase of Lumina Mortgage Company. The increase in other noninterest expenses of $69,000 was mainly due to an increase in professional fees. The increase of $26,000 in advertising can be attributed to a more progressive advertising and business development strategy.

In the three-month period ended June 30, 2002, noninterest expense increased 16.3% as compared to the same period last year. This increase can be principally attributed to compensation and fringe benefits and other expense increasing $301,000 and $36,000, respectively. The reasons for these changes are identical to the six-month period ended June 30, 2002.

INCOME TAXES

The effective tax rates for the six-month periods ended June 30, 2002 and 2001, were 35.4% and 36.0% respectively. The effective tax rates for the three-month periods ended June 30, 2002 and 2001, were 35.9% and

36.0% respectively. The decreases were mainly due to the fact that the earnings on Bank-owned life insurance are not taxable.

NOTE REGARDING FORWARD-LOOKING STATEMENTS

In addition to historical information contained herein, the discussion contains forward-looking statements that involve risks and uncertainties. Economic circumstances, the Company's operations, and the Company's actual results could differ significantly from those discussed in the forward-looking statements. Some of the factors that could cause or contribute to such differences are discussed herein, but also include changes in the economy and interest rates in the nation, changes in the Company's regulatory environment and the Company's market area.

ITEM 3 - MARKET RISK

The Company's primary market risk is interest rate risk. Interest rate risk is the result of differing maturities or repricing intervals of interest earning assets and interest bearing liabilities and the fact that rates on these financial instruments do not change uniformly. These conditions may impact the earnings generated by the Company's interest earning assets or the cost of its interest bearing liabilities, thus directly impacting the Company's overall earnings. The Company's management actively monitors and manages interest rate risk. One way this is accomplished is through the development of and adherence to the Company's asset/liability policy. This policy sets forth management's strategy for matching the risk characteristics of the Company's interest earning assets and liabilities so as to mitigate the effect of changes in the rate environment. The Company's market risk profile has not changed significantly since December 31, 2001.

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PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Not applicable

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

(a) Not applicable

(b) Not applicable

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

(a) Not applicable

(b) Not applicable

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY-HOLDERS

(1) Annual Meeting of Stockholders, April 26, 2002
(a) Election of Directors

	FOR		WIT
	NUMBER OF VOTES	PERCENTAGE OF VOTES	NUMBER OF VOTES
Paul G. Burton	2,383,836	90.22 %	258,428
H. Thompson King, III	2,384,636	90.25%	257,628
R. Allen Rippy	2,383,636	90.21%	258,628

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits - Exhibit 99 - CERTIFICATE PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

(b) Reports on Form 8-K

The Company filed a Current Report on Form 8-K dated July 17, 2002 to report second quarter earnings.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

COOPERATIVE BANKSHARES, INC.

Dated: August 14, 2002

/s/ Frederick Willetts, III

President and Chief Executive Officer

Dated: August 14, 2002

/s/ Todd Sammons

Treasurer and Chief Financial Officer